RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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July 10, 1985 LETTER 917

June 28 DJIA 1323.81; PTI 1863; A-D Ratio -14.33
July 5 DJIA 1334.45; PTI 1877; A-D Ratio -13.42

THE MARKET: Major market tops don't usually occur amid multi-upside confirmations. On June 27 we saw the following: new all-time highs in the D-J Industrial and Transportation Averages, new record highs on the S&P 500 and on the NYSE Composite and the NYSE Financial Index. On the same day my Primary Trend Index (PTI) hit a new record high of 1848, the A-D Ratio reached a new recovery high, and my on-balance volume index for the NYSE reached a new high.

The fly in the ointment (there's always a fly) was that new highs (NYSE) on June 27 were 102, down from 322 on June 5 and far below the peak of 454 new highs recorded on May 20. Nevertheless, the new high statistics can be misleading, and I've seen the highs turn down, then pick up again as a rally continued. I've also seen the market hold up for months after the new high index topped out.

Frankly, it's a very ticklish situation here. According to some of my studies, there is still quite a bit of technical strength built into this market. The short interest on the NYSE is at an all-time high, the margin balances (debits) are at a record high (which is bullish), institutional cash is building again but the speculative sectors of the market (NASDAQ, AMEX) are still lagging (usually at a market top the speculative sectors are boiling).

It is also true that good VALUES are hard to find in today's market. The latest reading for the yield on the Dow is 4.59%, rather low but not in the danger area of 3.5% or below. Price/earning for the Dow Industrial Average is 12.4, not far above the historical "fair" ratio of 10.

On the other hand, there are growing signs of upside resistance and churning (churning is high volume without appreciable upside progress, comparable to a person trying to run up a down escalator). One of the churning studies takes the daily differentials of advances and declines and runs these differentials in 25-day totals (it makes no difference whether the A-D differentials are plus or minus). If the 25-day totals are around 6,000 or below, this is an indication of little progress, and such situations often occur before a top. The 25-day total of the A-D differentials is now 6,800.

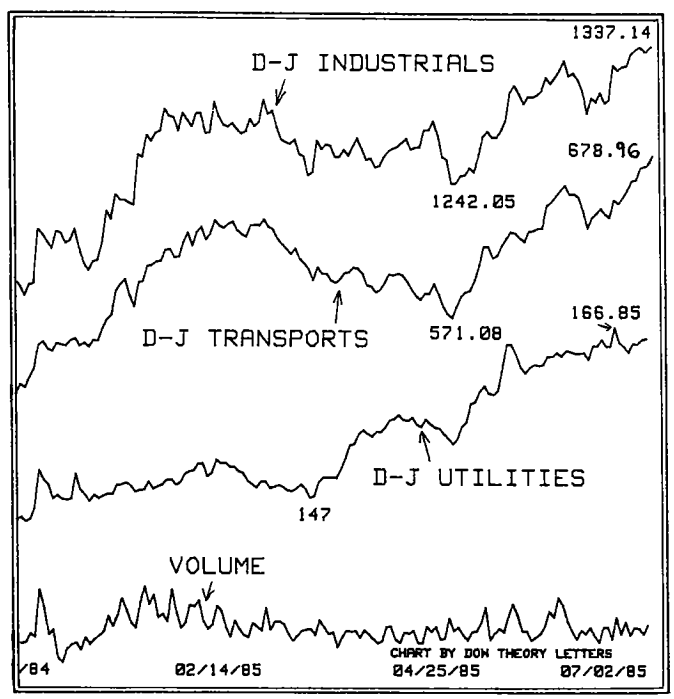
A variation of this is Market Logic's absolute breadth. Here the weekly advances and declines (NYSE) are simply added together and divided by the number of issues traded for the week. Market Logic puts these ratios on a 10-week moving average, and when the MA drops to around 15% a top is indicated. Currently, the ratio is around 22%, while the weekly figures are in the 20% area.

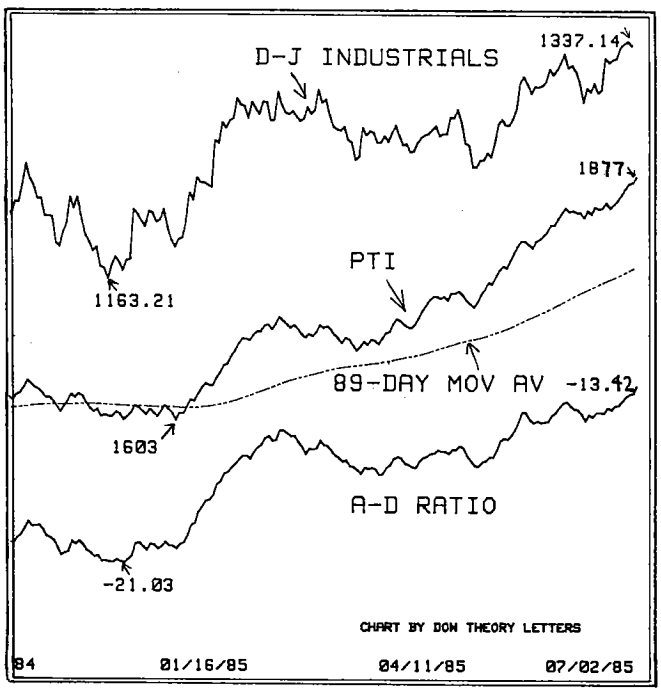
What do these churning studies indicate? Are we near a top? The truth is that I can't tell yet. If it's a market top we're looking at, it's a subtle one.

COMPARISONS: How have you done over the last six months? Here are the comparisons (July 1 against January 1, 1985): GM down 6.7%, IBM up 1.5%, D-J Industrials up 10.4%, D-J Transports up 20.5%, D-J Utilities up 10.6%, S&P 500 up 14.9%, Amex up 13.5%, Value Line up 12.9%, gold up 0.4%, silver down 5.9%, D-J 20 Bonds up 10.4%, CRB Futures Index down 7.9%, Treasury bonds up 13.8%.

There's a quantity of scare news flying around, but there are (strangely) not too many Wall Street bears. The scary news runs the gamut from shaky banks and unmanageable foreign loans to a recession in US manufacturing, a disaster in the electronics industry, a depression in agriculture and new peaks in the US (negative) trade balance and in the federal deficits. How has the stock market reacted to all this gloomy news? So far, very well. And a market that holds up in the face of horrible news is a market that deserves our respect.

I am mindful of the fact that "Wall Street can change its mind in a day", and one of the people looking for just such a change is my old friend Joe Granville. In his last Letter, Joe writes, "My conclusion is very simple: either the market crashes now or three months from now." Joe expects 1985 to resemble 1929 before 1985-86 is out. Time will tell.



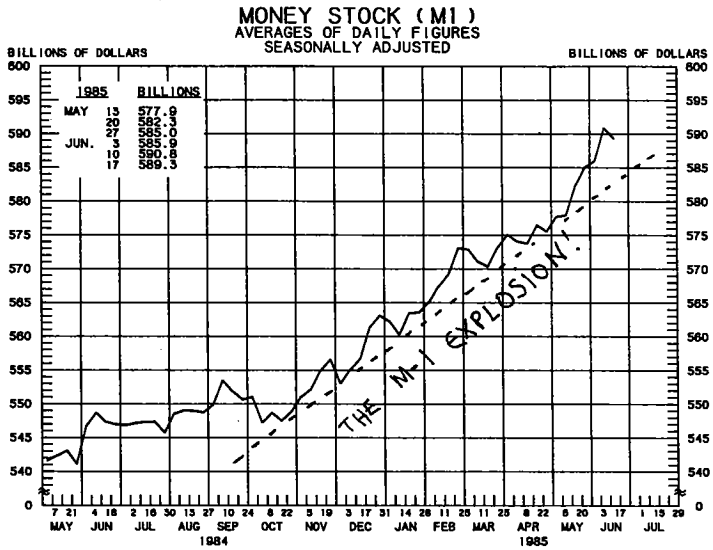


On the bearish fundamental side, S.Jay Levy and son David Levy ("Industry Forecast" of Chappaqua, NY) are anything but happy. This publication (with a long record of excellent calls) is now more bearish than I have ever seen it before. In their latest report, the Levys write, "The squeeze on (profit) margins will be the severest of the postwar period. Consequently, we are entering the most dangerous time for business and investors in many years."

Could the Levys be right? Sure they could. And I am well aware that thousands of very bright and powerful investors and money managers read their reports, and each of these men (and women) must decide (1) whether the Levys are right, and (2) if so, what they are going to do about it. In other words, the bearish view is well-known in both the corporate world and the investment world. What I want to see now is -- WHAT IS THE MARKET'S REACTION TO THE DISASTER SCENARIO?

If, in the period ahead, the market holds together or if it corrects mildly, such action will mean that any forthcoming bad news has already been discounted. But if the market's technical condition deteriorates, if the market starts to unravel, you can be sure that it is confirming the very bearish Levy view. And if the Levys are right, then I would think we could be heading for the nastiest Wall Street picture since 1973-74.

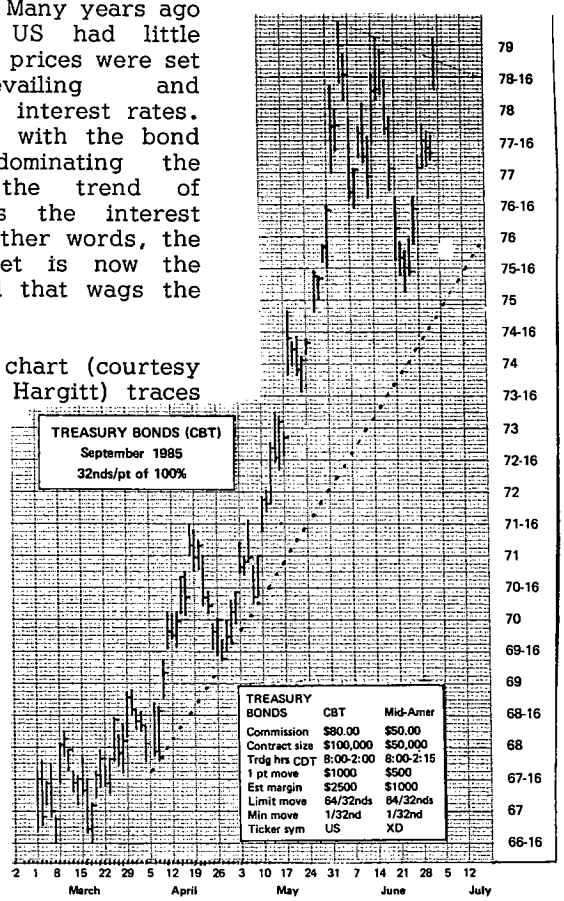
But hold on. Is there also a bullish scenario? Sure there is, and it's a good one. The bullish scenario centers on one phrase, "re-liquefication". The Fed is trying mightily to reliquefy the US economy. The Fed has been pumping for months. The M-1 figures are flying high. Since mid-February, the money stock (M-1) has risen at a compound annual rate of 12.0%. Obviously, the Fed is trying to turn this economy to the upside as fast as it can. The net result of the Fed's efforts, so far, has been to plunge interest rates near 10% on long-term bonds and to 7% on 91-day bills. Whether this re-liquefication will have the economy humming by yearend remains to be seen. And the stock market is watching the picture -- no, it is scrutinizing the picture.



One thought haunts me as I write this section. If, for the sake of argument, the US economy begins sliding into real recession in the next month or two or three, then Congress will be most reluctant to do any real deficit cutting (since cutting spending is deflationary). In that case, we could have a situation where there was a recession, the federal deficit was climbing to new record highs and the bond market was beginning to crumble (crumble in the face of sky-high deficits). As the bond market goes down, long-term rates go up. The last thing anyone would want to see was sliding business in the face of rising interest rates. But, as I've written so many times before, that's the great danger of recession -- in the face of a mountain of debts and deficits.

BONDS, RATES: As I've stated so often this year, the T-bond chart may now be the most important chart in the books. Many years ago when the US had little debt, bond prices were set by prevailing and forthcoming interest rates. But today, with the bond colossus dominating the markets, the trend of bonds sets the interest rates. In other words, the bond market is now the monster-tail that wags the dog.

This daily chart (courtesy of Dunn & Hargitt) traces


TREASURY BONDS (CBT)
September 1985
32nds/pt of 100%
TREASURY BONDS | CBT | Mid-Amer
Commission | $80.00 | $50.00
Contract size | $100,000 | $50,000
Trdg hrs CDT | 8:00-2:00 | 8:00-2:15
1 pt move | $1000 | $500
Est margin | $2500 | $1000
Limit move | 64/32nds | 64/32nds
Min move | 1/32nd | 1/32nd
Ticker sym | US | XD
March
April
May
June
July

the shooting-star path of the Sept. Treasury bond futures over the last five months. The peak came in early May at 79½, whereupon the contract dropped to just above 75 in mid-June. The trading limits now are clear enough. A breakout above 79½ would be very bullish for bonds. Such a rise would also mean that longterm interest rates were dropping to new lows. On the other hand, a break by the Sept. contract below 75 would mean gravy for bond short-sellers. It would also mean trouble for the stock market and the economy, since a plunge below 75 on the bonds would mean higher longterm rates. Note that any break below 75 would also reverse the rising trendline.

What do I think is going to happen? I wouldn't begin to guess here. Why guess when the perimeters (that's right, perimeter, not parameter) on the chart are so close? They are 79½ and 75. So far, I am still holding my own bonds.

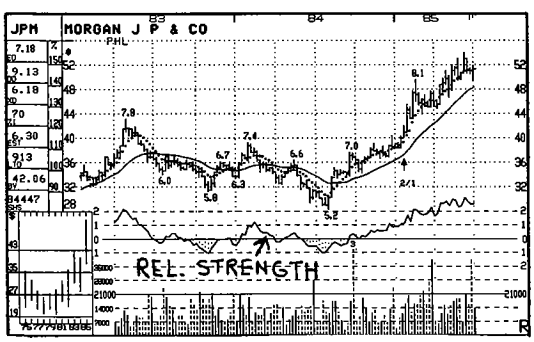
INVESTMENT POSITION: Market is short-term overbought, but all my bullish studies remain in place. The PTI is now 100 points above its 89-day moving average, a record. But this market continues to resist corrective forces, as the short sellers have been finding out.

Value Line lists timely stocks (those they like best for appreciation) and their #1 rated have an excellent record. Another category they list is safety, with #1 rated tops. Only six issues on the NYSE rate #1 in both categories. They are Johnson & Johnson, Kellogg, May Dept. Stores, J.P. Morgan, Pfizer, Wachovia Corp. They'd make a nice package.

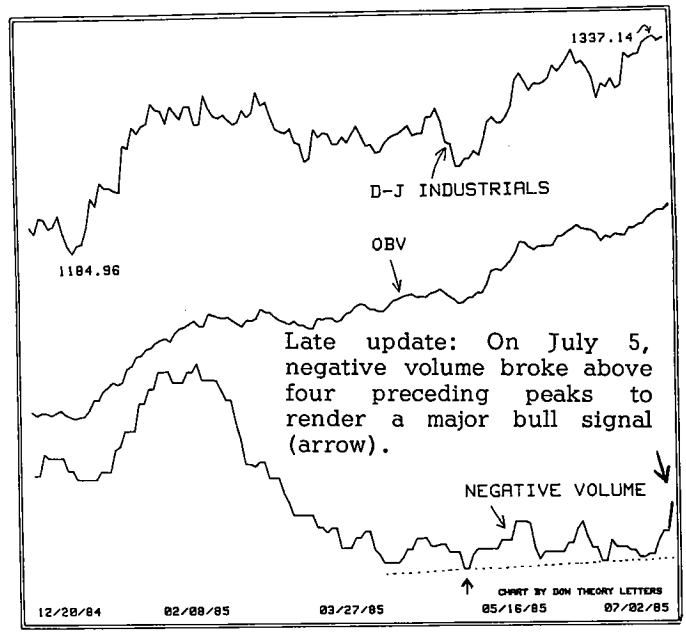
Strongest Dow stocks are Amer. Can, Amer. Express, Amer. T.& T., Exxon, Westinghouse, Woolworth.

If you haven't bought bonds by now, you haven't been reading Dow Theory Letters. But I feel bonds are a "hold" here. Sit tight. Precious metals -- see page 6.

Below is a chart of Morgan (holding company for Morgan Guaranty). I've been recommending this stock for over a year. I still like it. It's the only AAA-rated big bank left, and it's a class act -- and VERY profitable. Relative strength is good and the stock is climbing up its moving average (chart courtesy of Mansfield).



VOLUME: Ever since I started in this business I've been fascinated by stock market volume indications. Aside from daily volume on the NYSE, I follow three more specialized studies. The first is on-balance-volume on the NYSE. This is simply a running advance-decline total of the daily upside and downside volume differentials. In other words, if on a given day there was volume of 60 million on the upside and 15 million on the downside, I would simply add 45 million to the running total.



Volume tends to precede or at least move up or down in harmony with price. So in a bull market we would ideally like new highs in volume to coincide with new highs in price. New highs in price in the face of declining OBV would be a danger sign. Happily, as you can see on the accompanying chart, OBV has been hitting highs along with new record highs on the major averages.

Volume is broken into two other categories, positive and negative volume. Positive volume occurs on days when NYSE volume is ABOVE the volume of the preceding day. Negative volume is recorded on days when NYSE volume is BELOW volume of the preceding day.

Positive and negative volume is charted on the basis of the advance-decline differentials. If on a given day, there were 1000 advances and 300 declines, we have a differential of plus 700. If total NYSE volume on that day was below the preceding day, we have negative volume of plus 700. If NYSE volume was above the preceding day's volume, then it was positive volume and we have a positive volume day of plus 700. The two indices (positive and negative) are charted separately.

The theory is that "informed interests" prefer to do their market trading on quiet days or on negative volume days. Conversely, the public (which tends to be excited by rising volume) does its buying and selling on positive volume days. Thus, the more important of these two indices is the one that traces the action of the informed investors, and this is the negative volume index.

For technical reasons that I won't go into now, the negative volume index has a downward bias. In other words, during both bull and bear markets the negative index (over any lengthy period of time) tends to decline. But in powerful bull markets, the negative volume index will trend up for brief periods (and very occasionally for extended periods).

The accompanying chart traces the OBV and the negative volume indices from the beginning of 1984 to the present. On both readings, the story is bullish. The OBV is continuing its major uptrend, thereby confirming the new highs in the Averages.

The negative volume index turned up in May 1985. This represented the major impetus to the ride which is still going on. I might add that it is quite a feat for the negative index to mount a rally such as the first one seen in January on this chart. Such action is VERY bullish. Around mid-February the NV index turned down again in its normal way.

Then on May 1 the NV hit bottom and since then the NV has been rising very gradually. This gradual rise (since it is so difficult to achieve) is bullish. The implication is that even on days when market volume is down, there is a tendency for more issues to advance than decline. That is unusual -- and bullish.

VALUES: "To know values," wrote Charles Dow almost a century ago, "is to know the meaning of the market." Most investors and students do not realize that the great bulk of Dow's writing had to do with values. Dow advocated buying "great values" during periods when Wall Street and the economy were depressed, then selling those values when prosperity reigned and when Wall Street's spirits (and wares) were soaring.

Dow invented his Averages only to prove that the stock market (and human nature) moved in broad trends. It was to follow these major trends (i.e., bull and bear markets) that Dow used his Averages.

When I first started writing Dow Theory Letters back in 1957, the vast majority of stock market practitioners were following the fundamental approach, which is centered around values. Technical analysis at that time was literally forbidden; it was considered a branch of black magic. Times have changed. Now every bank and brokerage house has its technical department, and through the 1970s and early '80s the technical approach practically took over Wall Street.

But with the success of some of the fundamental funds such as Mutual Shares, Berkshire Hathaway, Sequoia, Lindner, etc., the fundamental (value) approach has returned with a vengeance. In fact, I would say that the best records in recent years have come from analysts and fund managers who concentrated on buying undervalued shares.

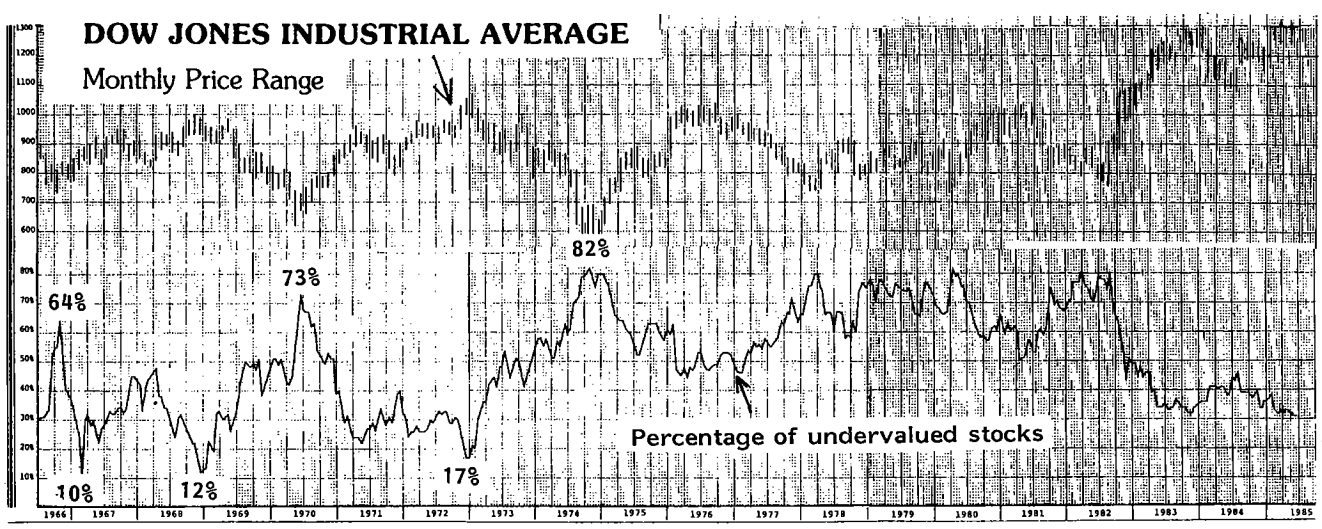
One of the very basic tests of value is the return on investment or the yield. Investment Quality Trends (7440 Girard Ave., La Jolla, CA 92037) does a fine job of tracking comparative yield values in hundreds of high-grade stocks. Based on yield, IQ Trends grades each of the stocks that they follow. They also run a graph based on the percentage of 350 blue-chip issues which IQ Trends classify as "undervalued".

I am including here IQ Trends' chart showing their percentage of stocks in the undervalued category. And it is amazing to see how helpful and accurate this chart has been in identifying major buying and selling areas for stocks. As a general rule, any time 70% of more of the 350 blue-chip stocks are in the undervalued zone, the market is near or at a great buy area. And any time 20% or less of the 350 stocks are in the undervalued area, the market is in a sell zone. Right now, as you can see on the chart, about 30% of the 350 blue-chip stocks are in the undervalued zone. Thus, the stock market is not in the danger zone yet, but it is not far away.

My conclusion is that any big upward push from here could put the stock market in a major sell mode. Ideally, what I would like to see is a period of gestation in which business improved, earnings increased and stocks simply marked time. If that happened, the percentage of stocks in the undervalued zone would rise, and the stock market would have considerably more room on the upside. To put it another way, a big rise (say 150 to 200 Dow points) from here could put the stock market at the brink. Personally, I hope it doesn't happen.

All this is confirmed in a recent speech by superstar investor Warren Buffet (chairman of Berkshire Hathaway). When Buffet talks, EF Hutton and everyone else listens. Here's what Buffet said (from Bottom Line, 330 W. 42 St., NYC 10036): "In today's stock market, equities are priced at an average of 30 to 40% above their intrinsic worth (their asset or book value). And I ask myself, 'What kind of return can corporations get on that intrinsic value?' I assume they can get 14% return on their assets, which sounds good in relation to today's bond yields. But there is a big problem. Since you are paying a 30% to 40% premium over the asset value, your rate of return is that much less. Then, when the return is taxed at capital gains rate, it turns out, on average, not very attractive compared with current tax-exempt bonds."

I approach the whole picture from a slightly different perspective. Here's the way I see it (from a value standpoint). I can get a tax-free safe income on California AA-rated muni bonds of 8.5%. In contrast, I can only keep about 50% of the income from taxable stocks and bonds. So I have to receive ro ghly a 17% return on a taxable investment to equal my return on



California munis. Can I find safe investments yielding around 17%? Maybe I'm stupid or lazy, but I don't think I can. Thus, from my standpoint, the current bargains in the securities markets are the better-rated munis, particularly those from my own state.

Question: Russell, that's all well and good, but what about inflation? If inflation roars in, your fixed return on the muni bonds is worth less, and on top of that your bonds will go down in price. What do you say to that?

Answer: Obviously, the inflation argument is the best argument against bonds. But I look at it this way. I have to earn 17% a year to equal my after-tax return on muni bonds. Over three years, a 17% return is slightly above 50%. So my muni bonds would have to drop in half before I would be out pre-tax money, based on an 8.5% tax-free return.

Of course, the ideal way to handle the inflation problem for bonds is to reinvest ALL your muni income in additional muni shares. Money at 8.5% doubles in less than nine years. So that's the gamble and those are the odds when you buy muni bonds. The gamble is that in 1994, reinvesting all your tax-free income, you will be able to keep up with whatever is happening by doubling your money. Will it work? I don't know, but it's one way to go, and it's a way that I think makes sense.

Ask yourself this: In 1994 will the Dow double (to 2600) plus enough additional points so that a seller in 1994 will be able to keep twice his original investment AFTER TAXES? I don't know. Of course, you can always diversify -- put half your income into Dow stocks and the other half in muni bonds. Then compound and see which half is ahead by 1994. Investing in a high-debt, high-tax, high-deficit society is anything but easy. And there's no guaranteed perfect answer.

NOTES & QUOTES: The current issue of Money magazine (July) runs a feature article on picking advisory letters. Nine are mentioned, but the magazine used me in the introduction. Here's what they say:

> Not all newsletter writers win their following by the stocks they pick or specific timing advice. Some are read for perceptive general observations. Consider Richard Russell, whose Dow Theory Letters (P.O. Box 1759, La Jolla, Calif. 92038; biweekly, $225) has never starred in the ratings. Mark Hulbert of Hulbert Financial Digest reports: "Russell's subscribers have on several occasions told me that they regard the receipt of an issue of Dow Theory Letters as akin to a visit by an old friend. They look forward to curling up in an armchair to read it." After devoting the first three pages of a recent issue to the general market outlook, Russell went on to ponder the connection between Freudian psychotherapy and investor mentality; discussed the pleasures of visiting New York City; gave some brief thoughts about football and horse shows; then returned to a discussion of the stock market, concluding: "The primary bull market is still very much intact on Wall Street."

At the end of the article Money reviews Dick Davis's Digest. Dick is a guy who receives 300 market letters, and he knows the business. Says Davis, "Longevity is the visible evidence of success in the newsletter business because the public will not pay for very long for bad advice." Since Dow Theory Letters has been in business since 1957, I take that as a compliment. And I'm already working on a special issue for January 1, 2000.

* *

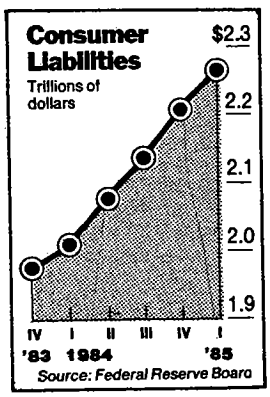
From our "In Case You Didn't See It" Dept.:

Excerpts from a speech about the budget deficit given by Senator Bob Dole, the majority leader, to a conference of local officials from New York, May 7:

We see our own budgets going up for staff. There's more staff around here than we need. They're all nice people. But the more staff you have, the more ideas you have, and most of them cost money. I haven't had many staff people come in with ideas to save money. It's always some new program to get their boss out front.

If you're hanging around with nothing to do and the zoo is closed, come over to the Senate. You'll get the same kind of feeling and you won't have to pay. You watch all these speeches being made and nothing going on at all and you think "Where am I? I can't believe this." But don't worry about it. If there are not many people there, you're lucky because you can't do business without a quorum. As long as there are only three to four people on the floor, the country is in good hands. It's only when you have 50 to 60 in the Senate that you want to be concerned.

The recent sluggishness in home and auto sales as well as orders for non-military durable goods should come as no surprise. Consumer liabilities, which include mortgages, installment andbank loans and other debt, soared to a record 72 percent of personal income in the first quarter and have been rising since.



"Consumer liabilities totaled an astounding $2.26 trillion on March 31, up from $2 trillion a year earlier," said Edward S. Hyman, chief economist at Cyrus J. Lawrence.

Although consumer assets rose to $6.9 trillion from $6.1 trillion in the same period, consumer spending will be inhibited during the rest of the year and possibly well into 1986 by the huge debt burden, Mr. Hyman says. The reason: Most of the li-

* *

Let's face it, the US budget deficits are still going wild, and the best I see from Congress (if we're lucky) is a few band-aids. I've been saying all along that the only real frontal attack on the deficit must come from a national sales tax or a value-added tax. The value-added tax is a tax on each step of manufacturing. In Europe the VAT has hit almost all nations, and it's a whopper. In Britain, it's 15%, it's 18% to 33% in France, 14% in W. Germany, 19% in Sweden, Italy 18%. To my mind, only the VAT or a sales tax will cut massively into the disgraceful US deficits.

* *

Last week the Commodities Futures Index did what I feared it would do. It broke below its October 1982 low of 225.8 -- to a new seven-year low of 224. On any reckoning, that's deflationary action. And this in the face of huge deficits and relentless Fed pumping.

The US farm economy is in shambles. There are surpluses in almost all categories of commodities and there are also huge structural changes such as massive increases in farm output in China and India (which were formerly big importers of farm goods). World sugar at 2.35 cents a pound, well under production costs. Copper is also priced below cost of production. As of last week, the NY Commodity Exchange showed a 132.9 million stock of silver, a record high. All this in the face of booming M-1 and record federal deficits. The forces of deflation, it seems to me, are very persistent.

* *

A Guggenheim Foundation grant has been provided to document the steel mill towns and their culture. Why? Because these towns are becoming a memory as the US heavy goods industries slowly crumble. Tony Buba is producing a documentary entitled "Wrapped in Steel". A Chicago project is doing the same thing in the Windy City where Jim Martin is videotaping 60 hours of mill community life. "Heavy industry is phasing out," said Martin. "That's what held the neighborhood together -- 50% of the community worked in the steel mills." It's worth pondering.

OPTIONS: Subscribers have undoubtedly noticed that I don't recommend options. I've always felt that buying options is as close as you can get to playing the crap tables at Vegas. In a recent report, The Professional Timing Service (PO Box 7483, Missoula, MT 59807) agreed with me. Its arguments make good sense: "By the time you pay the premiums involved (on the option) and commissions, you need a tremendous, sudden move in the underlying stock to make any big money."

And, of course, there is the matter of a time limit. When you buy an option you are playing against time, since all options have expiration dates (most options are purchased for six months or less).

What are the alternatives to buying options? Professional Timing Service suggests (and I agree) that you buy a low-priced stock. Assuming the company can stay in business, the low-priced stock (often cheaper than an option) constitutes a "perpetual option".

Example: If you think we are going into some kind of inflationary boom, you could buy cheap stocks like Ramada Inns, Lamson & Sessions or Equimark. These stocks (all near or below $10) would probably participate in a new boom. Obviously, I'm not predicting a boom, I'm making a point. The point is that between buying an option for $7 or a stock for $7, I'd much rather buy a stock (and I don't care what stock the option is on, the time factor is simply too great a negative).

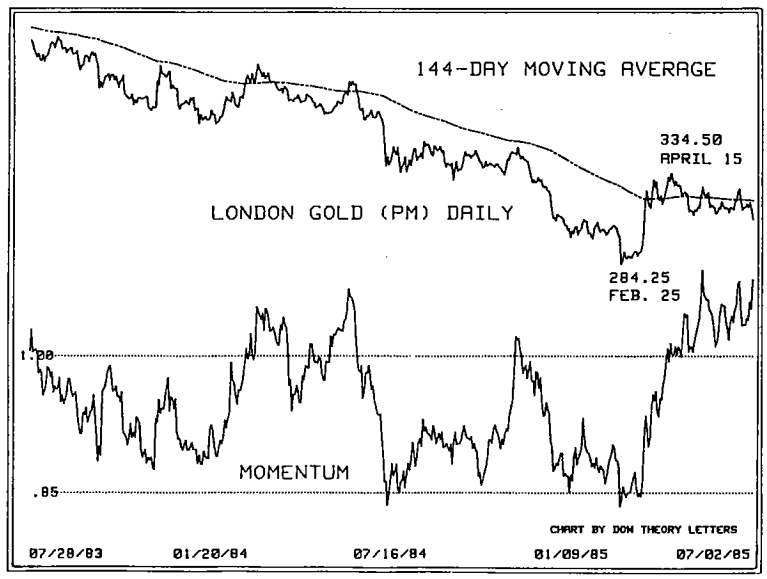
GOLD: Why do I concentrate on the gold metal rather than on gold shares? Simple, at this stage of the game the metal is the bellwether. Gold mining stocks are not like Procter and Gamble. PG makes hundreds of products, while a gold mine deals with one (although there may be a few metallic by-products). That one product is gold, and the major trend of gold will always dictate the major trend of the shares. Tell me that gold is in a bull market, and I'll buy every gold share in New York, Montreal, Toronto and South Africa. Tell me gold is in a bear market, and you can have all the gold shares listed anywhere.

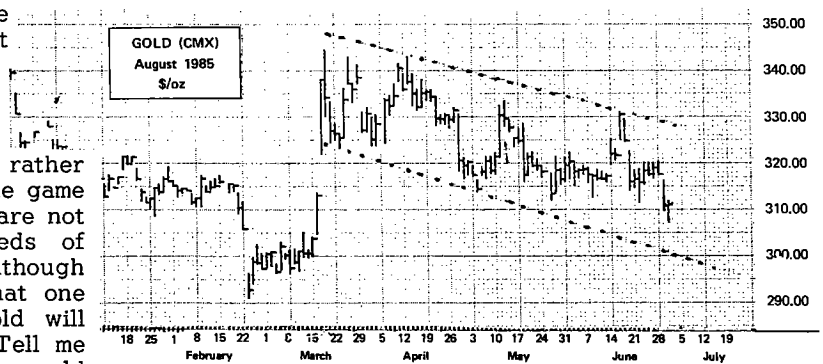
I know a lot of analysts look for confirmation between gold and the gold shares. That's fine when a major trend is established. Right now, however, I'm zeroing in on gold. The action of the metal will tell me all I need to know.

My basic study of gold, the 144-day (exponential) moving average and gold momentum is shown here. Although momentum (rate-of-change) is holding above 1.0, gold has not confirmed bullishly by holding above its 144-day moving average. This is discouraging for gold-philes. As you can see on the chart, gold since February has pushed its head above the moving average on five separate occasions. And following each effort, gold has plunged lower. The most recent drop (last week) took gold back to the 308-310 area. If gold cannot move up and out (above 334.50) in the next month, the momentum is going to turn bearish (below 1.0) again.

The daily chart (courtesy Dunn & Hargitt) shows gold moving along a bearish declining channel. The bottom of the channel comes in at about 300 now. A rally above 330 would be required to break gold out of the channel on the upside.

Conclusion: Gold remains in a bearish trend. The best we can say for it is that with many deflationary signs in the economy (not the least of which is oil), gold has not broken below its February low of 284.25.





LATE NOTES: Amazing bullish breakout by negative volume as the market ends last week with new record highs in the S&P 500, the NYSE Composite, the D-J 65 and my own PTI (at 1877). Bonds gapped higher. I don't know what this market sees ahead, but it sees something it likes. The best bull markets are the ones that continue to climb "without a reason".

NEXT MAILING: July 24